IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

NO. 702

CLARIDGE APARTMENTS COMPANY, a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF OF PETITIONER.

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List of Authorities Cited.

APPENDIX

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BRIEF OF PETITIONER.

Opinions of the Court Below.

The Petition of the Taxpayer prevailed in part and was overruled in part by the Tax Court. The opinion is found in 1 T. C. 163 (1943) and (Rec. 911).

The commissioner prevailed in the Circuit Court of Appeals for the 7th Circuit. The opinion is found in 138 F. 2nd 962 (1943) and (Rec. 228).

This court granted *certiorari* on the 27th day of March, 1944.

Jurisdiction.

1. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by Act of Feb. 13, 1925, 43 Stat. 938, 28 U. S. C. A. Section 347 (a).

2. The date of the judgment of the Circuit Court of Appeals of the Seventh Circuit herein sought to be reviewed, is Dec. 1, 1943, and petition for rehearing was denied December 22, 1943.

Statement of the Case.

On January 17, 1941, the Commissioner made a deficiency assessment of income tax liability amounting to $3,289.74 and $67.85 for excess profits taxes for the years 1935 to 1938 inclusive (Rec. 7).

The chief ground of assessment was that the basis of depreciation of taxpayer was the fair market value of the large apartment building of the taxpayer, on Aug. 1, 1935 of $132,500.00 as it was not a tax free reorganization (Rec. 9, 12, 15, 16, 18). On April 11, 1941, the taxpayer filed petition for redetermination of this assessment before the Board of Tax Appeals (Rec. 3). The chief ground of the petition was that taxpayer was the result of a tax free reorganization and the cost of the building to the transferor company of $424,609.49 was the correct basis of depreciation (Rec. 3, par. A. B. D.).

The commissioner denied this was the proper basis and asserted the fair market value on date of acquisition Aug. 1, 1935, was the correct basis on the ground it was not a tax free reorganization (Rec. 21, par. 4 A. B. C., 9, 12, 15, 16, 18). Just before the case was tried this Court handed down four important decisions which made the claims of

the commissioner very thin. Consequently at the trial without amending the pleadings, counsel announced he was going to rely on Section 270 of the Chandler Act as well, for his contention that the fair market value of the building was the correct basis of depreciation. *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U. S. 179; *Palm Springs Holding Corporation* v. *Commissioner*, 315 U. S. 185; *Bondholders Committee, Marlborough Investment Co.* v. *Commissioner*, 315 U. S. 189; *Helvering* v. *Southwest Consolidated Corporation*, 315 U. S. 194.

No claim was made orally or in writing that defaulted interest on 1st mortgage bonds was taken as a tax benefit by the taxpayer. The Tax Court found there was a tax free organization (Rec. 194); that section 270 did apply to the reorganization for the year 1938 and was not retroactive to the years 1935 to 1937 inclusive (Rec. 195, 196); that the words "cancelled or reduced", in Section 270 did not apply to an exchange of bonds for stock in a new company because the assets of the company were not freed from obligation but merely a capital stock liability was substituted for a debt obligation; that the cost of the building was $385,326.37 instead of $424,609.19, which had been taken as a basis of depreciation for 15 years (Rec. 184, 198); that there was no evidence in the record whether $80,022.20 of defaulted interest was taken as a tax benefit by the taxpayer and this question was not at issue in the case either by the pleadings or evidence, but deducted this sum from the cost of the building as a basis for depreciation and arbitrarily changed the rate of depreciation from 1925 to 1935 without any evidence to guide it and without this being an issue in the case (Rec. 197). It also disallowed certain deductions for 1937 for repairs and painting, without any evidence to support its finding.

The Circuit Court of Appeals for the Seventh Circuit, held Section 270 of the Chandler Act was retroactive and applied to the years 1935 to 1938 inclusive; that an exchange of bonds for stock was a cancellation within the meaning of Section 270 and the amount to be deducted from the cost of the building as adjusted was the difference between $277,000 face of the bonds, and the fair market value of the 2770 shares of stock received in exchange for the bonds; it found the fair market value was $45.00 per share. This deduction from the cost even of $424,609.19 as adjusted would bring the value of the building below $141,000, which was the market value of the building on May 14, 1935, the date the plan was approved. It held $141,000 should be taken as the basis of depreciation, as of May 14, 1935. It also affirmed the Tax Court of the United States in disallowing deductions of painting and repairs for 1937. It affirmed the Tax Court on the points appealed by the taxpayer in case No. 8296, and reversed the Tax Court in all points of the appeal in case No. 8297. In the Circuit Court of Appeals for the Seventh Circuit; the commissioner in his brief conceded it was a tax free reorganization within the meaning of Section 112 of the Internal Revenue Act of 1934.

The Claridge Building Corporation built a large apartment building in 1924 (Rec. 24, 25, 219). On March 25, 1925, it issued 1st mortgage bonds of $340,000 (Rec. 75). On Oct. 1, 1931 foreclosure proceedings were started for non-payment of interest (Rec. 76). The principal amount of bonds then due were $277,000 (Rec. 76). A decree of sale was had (Rec. 76). Then a reorganization was had at the instance of 93 per cent of the bondholders and all the stockholders (Rec. 75) in 77B proceedings whereby bondholders exchanged 277,000 face value of bonds for 2770

shares of stock of no par value in Claridge Apartments Company (Rec. 76). Stockholders of Claridge Building Corporation obtained 10 per cent or 308 shares of stock in Claridge Apartments Company (Rec. 77). All the property of Claridge Building Corporation was transferred to Claridge Apartments Company (Rec. 77, Par. 1; Rec. 79, Par. 4 and (a), (b), (c), (d); Rec. 80, 40, 81, 182).

Petition for certiorari was allowed by this Court in this case on March 27, 1944 and in the companion case No. 701. In case No. 701 we contend that the Circuit Court of Appeals erroneously found that Section 270 of the Chandler Act applied to this case at all as Claridge Apartments Company received no benefit from Section 268 of the Chandler Act since it was admittedly a tax free reorganization and apart from Section 268 of the Chandler Act, neither the corporation was taxable nor could any of its stockholders take losses from the reorganization; there was no debt forgiveness from the exchange or sale by bondholders of their bonds for Capital stock in the new corporation; that Section 276 (c) of the Chandler Act makes Section 270 applicable only to Corporations where reorganization proceedings were *pending* under Section 77b when the act became effective Sept. 22, 1922. The plan of reorganization in the case at bar was approved May 11, 1935 and the final decree was entered March 1, 1937 (Rec. 187); and the Chandler Act is not retroactive to cover the tax years of 1935, 1936, 1937, and prior to Sept. 22, 1938 because Section 276 (c) of the Chandler Act does not so provide.

We contend in this case that the tax court erroneously deducted from the basis of depreciation $80,022.20 defaulted interest on the theory it was taken as a tax benefit though admittedly there was no evidence of this and it was not at issue in the case by pleadings or evidence (Rec. 197).

If the court decides in case No. 701 that the Chandler Act does not apply at all to this case as neither it or its stockholders benefitted by Section 268 of the Act or because Section 276 (c) makes Section 270 applicable only to pending cases under Section 77b and not to finished cases, then the question whether the tax court properly deducted said $80,022.20 from the basis of depreciation becomes moot as it undoubtedly in that case improperly deducted that sum. If this court holds Section 270 does apply to this case, and affirms the tax court in every respect as to its applicability, then all the questions complained about in this appeal of case No. 702 are involved.

Assignment of Errors.

1. The Circuit Court of Appeals for the Seventh Circuit erred in affirming finding of Tax Court of the United States that the cost of the building in this case was $385,326.37 instead of $424,609.19 as the uncontradicted and unimpeached documentaary and oral evidence showed.

2. The Circuit Court of Appeals for the Seventh Circuit erred in affirming judgment of the Tax Court of the United States deducting $80,022 defaulted interest from the cost price of the building in this case when there was no issue on this question in the pleadings or evidence and admittedly absolutely no evidence supports such a finding.

3. The Circuit Court of Appeals for the Seventh Circuit erred in affirming decision of the Tax Court of the United States, changing the rate of depreciation of the building in this case over a period of ten years that had been allowed by the commissioner, without the rate of depreciation for that time being an issue in the pleadings

or evidence and no evidence of any kind supports such a finding.

4. The Circuit Court of Appeals for the Seventh Circuit erred in disallowing deductions for painting and repairs for the tax year of 1937 as the uncontradicted evidence showed these items were proper deductions.

ARGUMENT.

Summary.

I.

It was an error of law for the Tax Court arbitrarily and with no evidence to support it to find the cost price of the building was $385,326. 37 instead of $424,609.19.

P. C. Tomson & Co., Inc. v. Com., 82 Fed. Rep. (2d) 398 (C. C. A. 3rd Cir. 1937), p. 398.

Foster v. Com., 57 Fed. Rep. (2d) 516 (C. C. A. 5th Cir. 1932), p. 518.

OxFibre Brush Co. v. Blair, 32 Fed. Rep. (2d) 42 (C. C. A. 4th Cir. 1929), p. 44.

Nichols v. Com., 44 Fed. Rep. (2d) 157 (C. C. A. 3rd Cir. 1930), p. 159.

II.

When unimpeached documentary evidence and verbal testimony, uncontradicted, credible, and not improbable, are introduced, the Tax Court of the United States cannot disregard it but must accept it as true. The books of original entry and the testimony of Charles F. Henry show the cost of the building at 4501 Malden St., Chicago, to be $424,609.19. They are unimpeached, the evidence is credible, and not improbable.

Boggs & Buhl, Inc. v. Com., 34 Fed. Rep. (2d) 859 (C. C. A. 3rd Cir. 1929), p. 860, 861.

Pittsburgh Hotel Co. v. Com., 43 Fed. Rep. (2d) 345 (C. C. A. 3rd Cir. 1930), p. 347.

III.

The United States government, though a sovereign, when it litigates with a private citizen is estopped to make assertions just as private individuals are estopped, when equity requires it. For 15 years petitioner and its predecessor, reported the cost of its building to be $424,609.19 in its income tax returns. For 15 years respondent accepted this valuation when he could have demanded proof. He is now estopped to question this valuation.

State of Illinois v. I. C. R. R. Co., 246 Ill. 188 (1910), p. 248.

State of Indiana v. Milk, 11 Fed. Rep. 389 (C. C. D. Ind. 1882), pp. 396, 397.

U. S. v. Thelka, 266 U. S. 328 (1924), p. 339.

Walker v. *U. S.*, 139 Fed. Rep. 409 (C. C. M. D. Ala. 1905), p. 412.

IV.

A court has jurisdiction to decide only the issues presented by the pleadings. It cannot decide issues not presented by the pleadings. The Tax Court of the United States erred in finding that $80,022.20 should be deducted from the cost price of the building as adjusted, to find the basis for depreciation for income tax of 1938, on account of alleged use of defaulted interest on the bond issue by Claridge Building Corporation from 1931 to 1935 as provided in Section 270 of the Chandler Act, because that issue was not presented by the pleadings in the case, no evidence was taken thereon by either party, and the decision of the Tax Court of the United States is wholly unsupported by any evidence. All the evidence in the case was to the contrary. Furthermore no issue was

raised by the pleadings or the evidence as to the proper rate of depreciation of the building from 1925 to 1935. The Tax Court of the United States arbitrarily, without any evidence to support it, found that the cost of the building as depreciated on August 1, 1935 was $239,377.33. The cost using the original figure of $385,326.37 as found by the court, and the rate of depreciation allowed by the commissioner for fifteen years would be $246,082.66.

Reynolds v. Stockton, 140 U. S. 254 (1891), pp. 264, 266, 268.

J. P. Jorgensen v. Rapp, 157 Fed. Rep. 732 (C. C. A. 9th Cir. 1907), p. 738.

Munday v. Vail, 34 N. J. Law 418 (1871), p. 422.

V.

Insolvency once proved is presumed to continue until the contrary is shown. On Sept. 15, 1931, foreclosure proceedings were started against Claridge Building Corporation because of inability to pay interest on the first mortgage and taxes. From 1931 to Aug. 1, 1935, no interest was paid on the first mortgage but the whole accrued sum of $80,022.20 remained unpaid. $13,000 of general real estate taxes remained unpaid during that period. Only $8,000 was accumulated by the receiver during that period. Nearly $13,000 per year of depreciation was allowable on its accounting. During all this time it was operated by Trustee Melvin L. Straus. The original presumption and these proved facts tend to show that it was not necessary to take credit for unpaid interest on income tax returns.

Cleage v. Hardly, 49 Fed. Rep. 346 (C. C. A. 8th Cir. 1906).

Adams v. State, 87 Ind. 573 (1882), p. 575.

Wachsmuth v. Penn. Mutual Life Ins. Co., 147 Ill. App. 510 (1909).

VI.

The law is that if the Commissioner of Internal Revenue makes a finding of fact on substantial evidence, and no evidence is adduced to overcome this, it stands.

Where, however, the Commissioner of Internal Revenue made no finding of fact on the subject, it is error for the Tax Court of the United States to make one for him arbitrarily without any evidence. This it did as to $80,022.20 deducted from basis of depreciation on account of supposed use of defaulted interest as tax benefit under Section 270 of Chandler Act. There is no presumption of fact in this regard in the absence of evidence. The presumption in favor of Commissioner's finding is rebutted when the Tax Court makes a finding different from his.

City of Indianapolis v. *Keeley*, 167 Ind. 516 (1906), p. 527.

Andrews v. *Commissioner*, 135 Fed. Rep. (2d) 314 (C. C. A. 2nd Cir. 2-31-43), p. 318.

VII.

The finding of the Tax Court of the United States that $1,291.44 of decorating and $389.60 of repairs were charged in the returns of the taxpayer for both 1936 and 1937 is not supported by any substantial evidence and therefore should be reversed.

ARGUMENT.

I.

Petitioner's Exhibit 2 is a book of original entry, showing the cost of the building at 4501 Malden St., Chicago, Illinois (Rec. 219). Mr. Charles F. Henry, the general contractor for Claridge Building Corporation, kept it in his own handwriting except for minor parts because the various subcontractors were paid as the work progressed. It involved special knowledge of a builder to ascertain from time to time what each subcontractor was entitled to. That knowledge the bookkeeper did not have and Mr. Henry did have (Rec. 32, 33; 25, 26). So he put down in his own handwriting what was paid each subcontractor at the various times, and the cost of materials. This account book has been transferred bodily to this court from the Circuit Court of Appeals as it was too costly to print it. The book showed $385,326.37 as cost of materials and labor except for general contractor's profit of 10% or $38,532.64. That appears in pencil in the book. Mr. Henry also testified there were odds and ends that came up at the last minute not put down in the book which made the total cost $424,609.19 (Rec. 25, 26), which was the cost price put in all made income tax returns from 1925 to 1940, and was originally ascertained by him and his bookkeeper. The cost price was unquestioned by the government until they brought the proceedings in this case in 1940.

The respondent produced no evidence whatever to contradict the testimony of Mr. Henry on the book of original

entry. Yet the Tax Court of the United States, without any evidence to support their finding, found that the original cost of the 106 apartment building and four stores at 4501 Malden St., Chicago, was $385,326.27 (Rec. 184, 198). They did not disclose whether or not any of the court were builders and knew the testimony of Mr. Henry was wrong. They simply arbitrarily guessed that this figure was wrong and created a finding out of nothing that $385,326.37 was the correct figure.

It is an error of law for the Tax Court of the United States arbitrarily to make a finding of fact unsupported by any evidence whatsoever.

In the case of *P. C. Tomson & Co., Inc.* v. *Comm.*, 82 Fed. Rep. (2nd) 398 (C. C. A. 3rd Cir. 1935), p. 398, the question was as to the value of the "Red Seal Lye" brand on March 1, 1931. The commissioner introduced no evidence. The petitioner called five experienced witnesses who testified the value was from 9 to 10 hundred thousand dollars. The board put it in at $525,000.

The court said (p. 398):

> "We have searched the record and find no evidence whatever to support the Board's valuation. Such being the case, the Board's finding must be set aside as unwarranted and the determination of the commissioner approved."

In *Foster* v. *Comm.*, 57 Fed. Rep. (2d) 516 (C. C. A. 5th Cir. 1932), p. 518, the question was the value of timber on March 1, 1913, and in 1921. Two employees valued the timber at $5.00 per thousand in 1931, and $8.00 per thousand in 1921. In an estate the timber was valued in an inventory at $3.50 per thousand, $1.50 being deducted for

carrying charges. It had been sold for $5.00 per thousand when cut in 1920, the term of cutting being indefinite. The commissioner and board valued it at $3.50 per thousand in 1913 and $5.00 per thousand in 1921.

The Circuit Court of Appeals valued the timber at $5.00 per thousand both in 1913 and 1921.

The court said (p. 518):

> "We are not bound by a value the basis of which is arbitrarily or theoretically set down. The Board may not create; it must find in the evidence the value which it fixes."

In *OxFibre Brush Co.* v. *Blair*, 32 Fed. Rep. (2d) 42 (C. C. A. 4th Cir. 1929), p. 44, the president and treasurer owned 36% of the stock of a company, the balance of the stock being owned mostly by employees. They built the business from one losing over $3,000 per year to one making $158,753.07 per year.

In recognition of these services, the directors on May 6, 1920, voted each $24,000 additional salary. The Board of Tax Appeals interpreted this to mean $24,000 each additional salary for 1920 and disallowed these items on the ground there was no showing of extraordinary services in 1920 over other years. The Circuit Court of Appeals in reversing this decision said (p. 45):

> "We find no evidence whatever to support this conclusion."

In *Nichols* v. *Comm.*, 44 Fed. Rep. (2d) 157 (C. C. A. 3rd Cir. 1930), petitioner sold lands for cash and bonds in 1920. Four prominent men of the neighborhood testified the bonds had no market value and no money could be

borrowed on them at the time of the sale. Nevertheless, the commissioner and Board of Tax Appeals valued them at $11,000. In setting aside these decisions and affirming return of petitioner, the court said (p. 159):

> "Its own findings are not predicated on any substantial evidence and therefore its redetermination is set aside."

II.

When unimpeached documentary evidence and verbal testimony, which is not contradicted, is credible and not improbable, the Tax Court of the United States cannot disregard it but must accept it as true. The book of original entries of the general contractor, Charles F. Henry in his own handwriting made at the time of the building from day to day and known by him to be true, and not impeached in any way, certainly is the best evidence that may be obtained after 15 years acceptance of the figures by the commissioner. Mr. Henry satisfactorily explained all these figures after a lengthy cross examination by respondent. A court cannot create evidence out of its own mind of occurrences 16 years old, as it has attempted to do in this case, after a litigant has waited 15 years before challenging the correctness of this cost. After that time the memory even of the general contractor is dulled and he must rely to a certain extent on the book of original entries.

The Tax Court of the United States says it is not satisfied that Mr. Henry gave anything more than vacant lots to Claridge Building Corporation for the issuance to him of $100,000 par value of its stock (Rec. 198). The Tax Court of the United States valued the lots at $16,000 as of August 1, 1935 (Rec. 190). It can scarcely be said that

vacant lots worth $16,000 August 1, 1935 were worth $100,000 in March, 1924. Under the rulings of the Tax Court of the United States, Charles F. Henry would have subjected himself to a large stockholder's liability by transferring these lots to Claridge Building Corporation for $100,000 of its capital stock.

He contends, however, that he took this capital stock not only in payment for the lots but also in payment of his general contractor's commission of 10% of $38,532.64. In that way he could probably avoid any stockholder's liability which no ordinary business man would want to incur. It is submitted therefore that it is more credible to believe Mr. Henry was paid this commission in this way than to believe the finding of the Tax Court of the United States that he did not obtain this commission at all.

The Tax Court of the United States cannot disregard this uncontradicted testimony and create thus in its own mind evidence of occurrences 16 years old. This is error as a matter of law.

In *Boggs & Buhl, Inc.* v. *Comm.*, 34 Fed. Rep. (2nd) 859 (C. C. A. 3rd Cir. 1929), pp. 860, 861, the question was the value of the good will of a store. All the direct and expert testimony, by men of wide business experience in Pittsburgh where the store was located, was that the good will was worth a million dollars. There was no evidence to the contrary. Yet the Board found it worth $600,000. The Circuit Court of Appeals found it was worth $1,000,000, but under the law it could find only for $975,000.

The court said (p. 860):

> "A jury, commission or board may not arbitrarily ignore or discredit the testimony of unimpeached witnesses, so far as they testify to facts, and a wilful

disregard for such testimony will be ground for a new trial."

The court held that in matters of opinion the trial court could disregard the testimony of experts if it had some independent knowledge itself on the subject; that no such knowledge appeared in this case so the decision was reversed. Charles F. Henry testified as to a fact and not an opinion and his evidence, credible and unimpeached as it is, and corroborated, is binding on the court.

In *Pittsburgh Hotel Co.* v. *Comm.*, 43 Fed. Rep. 345 (C. C. A. 3rd Cir., 1930), p. 347, the dispute was as to the rate of depreciation of the Wm. Penn Hotel in Pittsburgh. Petitioner claimed 4% and the court and commissioner allowed 2%.

The commissioner had no evidence except two clerks in his office who had never seen the hotel and testified 2% was the usual allowance of the commissioner for a building of this character.

Petitioner put on six expert witnesses of Pittsburgh who were well acquainted with the hoted and Pittsburgh. They testified the hotel was "no longer up to date"; that hotels are occupied 24 hours per day and depreciate faster than office buildings which are occupied only part of the time, and that the smoke and grime of Pittsburgh make buildings depreciate faster both on the inside and outside than buildings in other cities.

The Circuit Court of Appeals ordered their determination set aside and the return of the petitioner approved on the ground it did not appear the trial court had any independent knowledge on the subject.

The court said (p. 347):

"It could not, therefore, arbitrarily disregard all the affirmative and positive testimony applicable to depreciation in this particular case."

III.

The United States Government, though a sovereign, when it litigates with a private citizen, is bound by all the equities that arise between litigating citizens including the equitable doctrine of estoppel.

The Commission of Internal Revenue if it wanted to question the cost price of the Claridge Apartments as shown in the income tax return of Claridge Building Corporation of 1925 as $424,609.19, should have done so when that return was made to it in 1925. Then everything was fresh in the taxpayer's mind and it could readily have proved beyond the peradventure of a doubt the exact cost. Instead, it waited 15 years to raise the point, accepting the figure every year from 1925 to 1940, before questioning it (Rec. 26, 27). The very fact that Mr. Henry, the general contractor, testified 16 years after he built the building for Claridge Building Corporation, instead of the next year after he built it would tend to make his testimony less worthy of belief as courts know the effect of 16 years on one's memory. A private suitor would be estopped at this late date to question this cost figure. So also is the government under the law.

In *State of Illinois* v. *I. C. R. R. Co.*, 246 Ill. 188 (1910), p. 248, the defendant was required by contract to pay as a tax to the State of Illinois 7% of its gross earnings and report twice per year its earnings to the State. It made these reports from October 31, 1877 to 1905. During that

period its accounts were never questioned. They were subject to examination by the governor for the time being. The State of Illinois in 1905 filed a bill claiming proper accounting had not been made over this span of years. The court held the State was estopped to say that a proper accounting had not been had.

The court quoted from Chief Justice Marshall in the case of *Choppendelaine* v. *Deschixaux*, 4 Cranch. 305:

> "No practice could be more dangerous than that of opening accounts which the parties themselves have adjusted, on suggestions supported by doubtful or by only probable testimony."

In our case there was absolutely no testimony.

The court also said:

> "Lapse of time necessarily obscures the truth and destroys the evidence of past transactions."

In *State of Indiana* v. *Milk*, 11 Fed. Rep. 389 (C. C. D. Ind. 1882), pp. 396, 397, the State of Indiana was granted land including a lake by the Government. The State sold some of the land to individuals. Then it purchased odd numbered lots from individuals and taxed them on the even numbered lots. Then it sought to get back land covered by the lake on the ground individuals had riparian rights only to the water's edge. The court held the statement of law was correct but the State was estopped so to assert by its taxing the even numbered lots and buying the odd numbered.

The court said (p. 397):

> "Resolute good faith should characterize the conduct of States in their dealings with individuals, and

there is no reason, in morals or law, that will exempt them from the doctrine of estoppel."

In *U. S.* v. *Thelka*, 266 U. S. 328 (1924), p. 339, in a libel case, where the government intervened, and the court held it was subject to the justice of the matter the same as if it had been an individual.

See also *Walker* v. *U. S.*, 139 Fed. Rep. 409 (C. C. M. D. Ala. 1905), p. 412.

IV.

A court can only decide the issues presented by the pleadings. Any decision outside the pleadings is void. $80,022.20 was deducted from the cost price of the building for the income tax year of 1938 by the Tax Court of the United States (Rec. 206, last line), when the issue on which it was deducted was not raised by the pleadings in the case and no evidence was introduced on the point by either side (Rec. 9, 12, 15, 16, 18, 3, par. 4 (a), (b), (c); Rec. 21, par. 4 (a to h); Rec. 197).

The pleadings in this case consisted of a petition for a redetermination of deficiency income and excess profits taxes for the years 1935 to 1938 inclusive, and an answer thereto. The petition alleges (par. 4 (c), Rec. 3), as follows:

> "(c) The Internal Revenue Department of the United States erred in not holding that Petitioner took title in a tax free reorganization under the Internal Revenue laws of the United States and was entitled to take as a basis for depreciation the cost of the property to its predecessor in title."

As a part of the petition was Exhibit "A" which was notice of deficiency assessment of Jan. 17, 1941. As to

each year from 1935 to 1938 inclusive, the ground of the deficiency assessments except as to some painting and decorating and repairs, was asserted to be:

> "It has been determined that your basis for depreciation on the apartment building was the fair market value of the property on the date you acquired it, August 1, 1935 or $182,500."

The answer of respondents to this portion of the petition, is as follows (Rec. 21):

> "4 (a) to (h) inclusive. Denies each and every allegation of error contained in subparagraphs (a) to (h) inclusive of paragraph 4 of the petition."

The issue then is clear whether or not, on August 1, 1935, there was a tax free reorganization or the market value of the building on August 1, 1935, was to be taken as the basis for depreciation in income tax returns.

If there were any scaling down under Section 270 of the Chandler Act, it was accomplished by order confirming the plan entered May 14, 1935 (Rec. 84). The market value of the building on that date or whether unpaid interest had been used as tax benefits, were not put at issue by the pleadings or the evidence in this case. It is entirely inadmissible for the Tax Court of the United States to deduct $80,022.20 from the cost prire of the building as of Jan. 1, 1938 to obtain a basis for depreciation for income tax purposes for that year (Rec. 206, last line). That question was not raised by the pleadings or the evidence as the opinion of the Tax Coort of the United States admits (Rec. 197). All the evidence in the record points to the fact that such defaulted interest was not used as a tax benefit. The commissioner never made a finding that it was so used.

There is no presumption in his favor. The Tax Court of the United States was absolutely without any evidence whatsoever on which to base this finding. Such a finding cannot stand as shown by the authorities shown in Point I of this argument.

In *Reynolds* v. *Stockton*, 140 U. S. 254 (1891), pp. 264-266, 268, a New Jersey Insurance Corporation took over a New York Insurance Corporation. On insolvency of the New Jersey corporation, a stockholder and policy holders brought suit in New York to have assets of the insurance corporation deposited in New York applied in satisfaction of obligations to the policy holders of the New York insurance corporation. Without amending pleadings, the plaintiff in this suit obtained a judgment for $1,000,000 against the New Jersey insurance corporation and its receiver.

The Court of Chancery of New Jersey ignored this judgment and the Supreme Court of New Jersey and of the United States affirmed this action. It was held the judgment for $1,000,000 was void because no issue was made by the pleadings in the New York suit, whereby it could be rendered and there was no denial by New Jersey of the effect of the New York judgment in violation of the federal constitution, Article 4, Section 1.

The court said (p. 268):

> "A judgment upon a matter outside of the issue must, of necessity, be altogether arbitrary and unjust, as it concludes a point upon which the parties have not been heard."

In *J. P. Jorgenson* v. *Rapp*, 157 Fed. Rep. 732 (C. C. A. 9th Cir. 1907), p. 738, there was a suit for replevin of logs.

Defendant pleaded denying title and right to possession in plaintiff, and sought to set up a *quantum meruit* for services in reclaiming logs in the sea. This set-off was twice stricken. The lower court found issues for plaintiff, but did not enter judgment thereon, but entered judgment in favor of defendants for services in reclaiming logs in amount of $477.00. The plaintiff brought suit to enjoin enforcement of judgment as no appeal lay for a judgment under $500.00 then. The lower court denied preliminary injunction, but the Circuit Court of Appeals ruled it should have been entered as the judgment was void as beyond the issues of the case. The court had no jurisdiction to enter it.

In *Munday* v. *Vail*, 34 N. J. Law 418 (1871), p. 422, there was ejectment suit brought. The defendant claimed he obtained judgment against the owner who promised to secure it with the land, but instead conveyed the land to a trustee for himself and wife, their survivor, and children. The lower court set aside the deed of trust and vested title in defendant. It was held the decree was void insofar as it set aside title to infant defendant given by this trust as such relief was not prayed in the bill, and the question was not at issue.

V.

An insolvent condition whereby interest on first mortgage and taxes are not earned once proven is presumed to continue (Rec. 76). The Court takes judicial notice of the depression years of 1931 to August 1, 1935. It appears in the record that on October 1, 1931, foreclosure suit of the first mortgage on the realty at 4501 Malden St., Chicago, Illinois, was filed for non-payment of taxes and interest on first mortgage (Rec. 76).

If the Claridge Building Corporation then could not pay its taxes and interest, there was no need of resorting to interest to prevent the paying of income taxes for 1931. Besides during all these years it had nearly $13,000 deductible each year from the income of the property, being 3% of the cost of the building allowable for depreciation (Rec. 26, 27). Then Melvin L. Straus, as Trustee of the property, was put in charge of the property by the State court for the benefit of bondholders. He continued in such possession while the matter was in the federal court under Section 77B of the Federal Bankruptcy Act, being in possession from October 1, 1931 to August 1, 1935. During that period no interest on the first mortgage was paid, and taxes up to $13,000 remained unpaid. During all this time, nearly $13,000 was deducted yearly from the income for depreciation on the property (Rec. 93, 95). Yet the Tax Court of the United States on some kind of presumption, it does not describe, and admittedly without a syllable of evidence to support its findings, held that the Claridge Building Corporation took the benefit of this unpaid interest as an income tax benefit for all these years. I submit that the evidence shows it was exceedingly unlikely that such benefit was taken and that the Tax Court of the United States erred as a matter of law, at all events, in this finding, without a syllable of evidence and without any presumption to support its finding. It is submitted the evidence, if it became material under the pleadings, would have shown no such benefit was taken.

In *Cleage v. Lardley*, 149 Fed. Rep. 346 (C. C. A. 8th Cir. 1906), the question was whether a preference was given while debtor was insolvent. It was proved he owed $25,000 in July, and had assets of only $50,00. In December following the alleged preference was made. It was held there

was a presumption that he was insolvent in December from proof of his insolvency in July.

In *Adams* v. *State*, 87 Ind. 573 (1882), p. 575, the question was whether a conveyance of real estate was fraudulent and void. It was proved debtor had no property except that conveyed to his wife in November 1876. It was held jury might infer from this fact he had no other property in December 1877, when the action was instituted.

The court said (p. 575):

> "It is a fundamental doctrine that when a fact is once shown to exist, the presumption is that it continues to exist and this presumption stands good till the contrary is shown or a countervailing presumption is raised."

In *Wachsmuth* v. *Penn. Mutual Life Ins. Co.*, 147 Ill. App. 510 (1909), the validity of a sale of real estate to pay debts in a deceased estate depended on whether the executors were insolvent at the time it was made. They owed the estate $10,000. It was held that if it was proved they were insolvent at the time of the death of the deceased, it would be presumed they were insolvent at the time of this sale.

VI.

There is no presumption of fact in favor of the commissioner, unless he has made a finding of the fact in assessing the tax. The commissioner, in his notice of deficiency tax of date January 17, 1941 (Rec. 7), bases each explanation of adjustments for the income tax returns of 1935 to 1938 inclusive on the ground that

> "Your basis for depreciation on the apartment building was the fair market value of the property on the

date you acquired it, Aug. 1, 1935, or $132,500" (Rec. 9, 12, 15, 16, 18).

There was no claim of the fair market value on May 14, 1935, the date the plan of reorganization was confirmed, nor any finding that tax benefit had been claimed for unpaid interest from 1931 to August 1, 1935.

There is no presumption of fact or of law that such interest was so used as a tax benefit and if the commissioner claims it was so used he must prove it. Taxpayers are entitled to know the basis of determination of tax deficiencies and to rest assured that no basis not given by the commissioner in making his decision will be later claimed by him unless he at least gave notice thereof. A good case showing under what circumstances presumptions of law and fact arise is the following:

In *City of Indianapolis* v. *Keeley*, 167 Ind. 516 (1906), p. 527, the lower court instructed the jury in a personal injury case from defective sidewalk that there was a presumption the plaintiff exercised due care in walking on the sidewalk. This was held error on the ground a presumption of law arises from such inferences as are warranted from legal experiences of courts in rendering justice and presumptions of fact are inferences which enlightened common sense may draw from facts and circumstances.

In the case of *Andrews* v. *Commissioner of Internal Revenue*, 135 Fed. Rep. (2d) 314 (C. C. A. 3rd Cir. 3-31-43), p. 318, a reorganization provided interest on bonds may be paid in scrip of the corporation. The question was the value of this scrip as income in the hands of bondholders. The commissioner valued it at $50.00 in October 1935, $52.00

for November, 1935, and $41.00 for December 1936. The Tax Court of United States valued it at $35.00. The court held the presumption in favor of the valuation of the commissioner is rebutted when there is no substantial evidence for his price figure, and there was no reasonable basis for the finding of the Tax Court. The evidence on the point was so speculative and uncertain as to form no basis even for a guess.

VII.

The finding of the Tax Court of the United States that in the income tax return for 1937, $1,291.44 for painting and decorating and $389.60 for repairs, was deducted from gross income, though these same items had been deducted in the income tax return of 1936, is without any proof in the record to substantiate it and under the decisions cited in Point I of this argument cannot stand.

The only witnesses who testified on the subject are Charles F. Henry and Milton C. Kuehn.

After November, 1937, Mr. Henry was president of Claridge Apartments Company. He testified he examined the daily records of decorators, the actual bills, and that the figures claimed in the 1937 return of decorating and repairs are correct (Rec. 31, 32).

Mr. Kuehn testified he made out the 1936 income tax return, but had nothing to do with the 1937 income tax return. He testified that in 1936 all the items of painting and decorating and repairs incurred in 1936 were deducted; that the company then in its bookkeeping had a system of deferring the painting and decorating on its books, charging it against each apartment. *He nowhere testifies that*

It is further submitted the lower court committed error as matter of law in deducting from the basis of depreciation for the year 1938, $80,022.20, as unpaid interest on the first mortgage allegedly used as an income tax benefit for the years 1931 to August 1, 1935, when there is no evidence that such was the case and no issue was made on this subject either by the pleadings or the evidence.

Respectfully submitted,

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APPENDIX.

Section 112 (g) 1 (B) of Income Tax Law of the United States for year 1934. 26 U. S. C. A. p. 695 (a) Definition of Reorganization as used in this Section and Section 113.

(1) "The term "reorganization" means * * * (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock * * * of substantially all the properties of another corporation."

"Section 112 (g) (1) (D) (2). The term 'a party to a reorganization' includes * * * both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another."

Section 112. Reorganization of Gain or Loss. * * *

(b) Exchanges Solely in Kind. * * *

(3) Stock for Stock on Reorganization.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) Same.—Gain of Corporation.—No gain or loss shall be recognized if a corporation a party to a reorganization exchanged property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(5) Transfer to Corporation Controlled by Transferror. —No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in

exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; * * *"

Section 113 (a) (6) Revenue Act of 1934, 26 U. S. C. A. p. 697.

(6) Tax free exchanges generally. If the property was acquired after February 28, 1913, upon an exchange described in 112b to e inclusive, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the Taxpayer and increased in the amount of gain or decreased in the amount or loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted in Section 112 (b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it."